APPLYING THE FRAUD-EXCLUSION PROVISION UNDER D&O INSURANCE POLICIES: "ADJUDICATION" OR "IN FACT" – WHICH IS BETTER?

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I. INTRODUCTION

Directors and Officers liability insurance (D&O insurance) is a type of casualty coverage that is designed to protect directors and officers (D&Os) from personal loss and to reimburse companies for indemnity payments made to their D&Os.[1] A typical D&O insurance policy, like many other insurance policies, includes an exclusion section listing the areas of liability that the policy does not cover.[2] One common exclusion is the "fraud exclusion," which excludes coverage of claims based on an insured's fraudulent act.[3] In theory, the fraud exclusion applies "only when there is an actual finding of dishonesty or fraud against a particular insured."[4] In practice, however, how to define "actual finding" remains a critical issue and courts have taken different approaches.[5]

Some courts have held that fraud-exclusion provisions apply only when there is a finding of dishonesty or fraud material to the adjudicated cause of action.[6] Other courts have held that fraud-exclusion provisions excluding commission "in fact" in a fraud-exclusion provision requires proof of either evidentiary facts or a final adjudication.[7] Another court focused on the broad definition of "claim" under an insuring agreement and held that fraud-exclusion provisions do not apply to securities claims, even if the fraud is deliberate.[8]

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[1] Lowell E. Sachnoff, *Recent Developments in Litigation Interpreting Directors and Officers Liability Insurance Policies*, C568 ALI – ABA 153, 158 (1990).
[2] JOHN F. OLSON ET AL., DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE § 12:5 (2014-2015 ed. 2014).
[3] *Id.* at § 12:14.
[4] MICHAEL R. DAVISSON ET AL., DIRECTORS & OFFICERS LIABILITY INSURANCE DESKBOOK 118 (3d ed. 2011).
[5] Alan Rutkin, *The Dishonesty, Personal Profit, and Money Laundering Exclusion in D&O and E&O Insurance*, 41 BRIEF 25, 25 (2012).
[6] *See* AT & T v. Clarendon Am. Ins. Co., No. 04C-11-167-JRJ, 2008 WL 2583007 (Del. Super. Ct. June 25, 2008).
[7] *See* PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., No. C 02-1774 PJH, 2006 WL 825266 (N.D. Cal. Mar. 29, 2006).
[8] *See* Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376 (D. Del. 2002).

The "adjudication" approach under *AT & T* requires an adjudicated fraud to trigger the exclusion.[9] This approach provides a clear guidance in practice. In fact, the court in *AT & T* went even further and held that settlement of the underlying claim would render the fraud-exclusion provision inapplicable.[10] As a result, an insurer cannot challenge an insured's fraudulent act once the underlying claim is settled, even if the fraud is clear.[11]

In contrast, the "in fact" approach under *PMI* requires either adjudication or some evidentiary proof of fraud to trigger the fraud-exclusion provision.[12] This approach can better protect an insurer's legitimate interests in preventing fraud. But the "some evidentiary proof" standard under this approach raises another issue: how much evidence is sufficient?

To strike a balance between an insured's reasonable expectation of coverage and an insurer's legitimate interest in preventing fraud, the "adjudication" approach is a better choice. If an insurer can satisfy a heightened pleading requirement and establish a fraud by clear and convincing evidence, the insurer should be allowed to raise the fraud exclusion subsequent to a settlement of the underlying claim.

II. BACKGROUND

Corporate D&Os throughout the United States are facing "[a]n alarming amount of litigation" arising out of their corporate capacity and status.[13] D&Os' liability generally stems from three main sources: (1) shareholder claims for breach of duty of care,

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[9] AT & T v. Clarendon Am. Ins. Co., No. 04C-11-167-JRJ, 2008 WL 2583007, at *6 (Del. Super. Ct. June 25, 2008).
[10] *Id.* at *7.
[11] Rutkin, *supra* note 5, at 25-26.
[12] PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., No. C 02-1774 PJH, 2006 WL 825266, at *8 (N.D. Cal. Mar. 29, 2006).
[13] Robert H. Rosh, *New York's Response to the Director and Officer Liability Crisis: A Need to Reexamine the Importance of D & O Insurance,* 54 BROOK. L. REV. 1305, 1305 (1989).

duty of loyalty, and/or duty of good faith; (2) claims from "disgruntled employees, consumers, and customers . . . [for] failure to comply with [various regulations], tort claims for pollution, and violations of civil rights";[14] and (3) claims under the federal securities law.[15]

With potential liabilities stemming from various sources, D&Os are exposed to substantial judgment or settlement amounts plus attorney fees for defending claims.[16] "Individuals considering whether to become a director or officer are bitterly aware of the large judgments rendered against corporate directors and officers in recent years."[17] A 1987 survey shows that about "10% of the large corporations surveyed reported that a prospective director nominee had declined the honor of serving on the board because of the fear of possible personal liability, and 85% of the chief executive officers surveyed believed that a director and officer liability 'crisis' had arrived or was imminent."[18] The 1998 Directors and Officers Liability Survey by Tillinghast-Towers Perrin shows that "claims against officers and directors continued the upward trend . . . ."[19]

Faced with the liability crisis, D&Os "have become increasingly concerned with how to best immunize themselves from personal liability exposure."[20] Corporate indemnification and D&O insurance are the major sources of protecting D&Os from such liability.[21]

A company may indemnify its D&Os in connection with actions brought against them by virtue of their positions under

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[14] *Id.* at 1308-10.
[15] OLSON ET AL., *supra* note 2, at § 1:1.
[16] Kurt A. Mayr, II, *Indemnification of Directors and Officers: The "Double Whammy" of Mandatory Indemnification Under Delaware Law in Waltuch v. Conticommodity Services, Inc.*, 42 VILL. L. REV. 223, 230 (1997).
[17] *Id.*
[18] OLSON ET AL., *supra* note 2, at § 1:1.
[19] *Id.*
[20] Rosh, *supra* note 13, at 1305.
[21] Joseph P. Monteleone & Nicholas J. Conca, *Directors and Officers Indemnification and Liability Insurance: An Overview of Legal and Practical Issues*, 51 BUS. LAW. 573, 574 (1996); OLSON ET AL., *supra* note 2, at § 12:1.

various circumstances.[22] Under common law, D&Os have no right to corporate indemnification, and their right to indemnification is purely statutory in nature.[23] Beginning in the 1940s and 1950s, state legislatures and courts began to recognize the legitimacy of D&O insurance.[24] However, indemnification still cannot fully protect D&Os from personal liability.[25] For instance, indemnification may not be available when: a company becomes insolvent or goes into bankruptcy; the court finds that D&Os acted in bad faith; there is an adverse judgment against D&Os in a derivative action; or the state and federal law or public policies prohibit it.[26]

D&O insurance not only protects corporations from sizable losses by indemnifying their officials, but also protects the individual officials against certain losses when corporate indemnification is not available.[27] Both the Model Business Corporations Act and the Delaware General Corporation Law recognize its legitimacy.[28] "[C]orporations could purchase and maintain insurance on behalf of directors, officers, and employees for service in virtually any official capacity, regardless of whether the corporation would have authority to indemnify such persons as a matter of state law."[29] A 1998 survey shows that about 92% of U.S. companies bought D&O insurance; and among the largest companies (with assets above ten billion dollars), over 95% had D&O insurance policies.[30]

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[22] 19 C.J.S. *Corporations* § 577 (2013).
[23] *Id.*
[24] *See* Monteleone & Conca, *supra* note 21, at 574.
[25] *See* OLSON ET AL., *supra* note 2, at § 12:1.
[26] *See id.* at § 12:3.
[27] *Id.* at § 12:1.
[28] *Id.* at § 12:2.
[29] *Id.*
[30] *Id.* at § 12:3.

III. STRUCTURE OF A D&O INSURANCE POLICY

Modern D&O insurance policies generally provide three types of coverage.[31] The first type (Side-A) protects individual D&Os by providing them coverage for losses arising from a wrongful act.[32] The second type (Side-B) reimburses companies for indemnity payments made to their D&Os.[33] The third type (Side-C) indemnifies companies for the cost of defending certain claims.[34]

A typical D&O insurance policy includes the following parts: Declarations Page, Insuring Clauses, Exclusion Section, General Terms & Conditions, and Endorsement.[35] The Declarations Page lists, among other things, the parent organization, limits of liability, coinsurance percent, deductible amount, and insured persons.[36] Insuring Clauses are the principal agreements between parties under the policy.[37] The Exclusion Section describes the areas of liability that the policy does not cover.[38] The General Terms & Conditions "establish important procedures, presumptions and conditions to coverage."[39] Endorsements are other side agreements between the parties.[40]

IV. ANALYSIS OF D&O INSURANCE POLICY PROVISIONS

To trigger coverage under a D&O insurance policy, three preliminary requirements must be satisfied: (1) the "'claim' must

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[31] DAVISSON ET AL., *supra* note 4, at 29.
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] OLSON ET AL., *supra* note 2, at § 12:5.
[36] *See* KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION: CASES AND MATERIALS 590 (5th ed. 2010).
[37] OLSON ET AL., *supra* note 2, at § 12:5.
[38] *Id.*
[39] *Id.*
[40] *Id.*

have been made against the insureds during the policy period; (2) the claim must be for a 'wrongful act' committed by the insureds[;] and (3) the insureds must have experienced a 'loss.'"[41]

First, D&O insurance is a claims-made policy.[42] It covers "claims first made against the insured parties while the policy is in force regardless of when the events or transactions underlying the claim occurred."[43] Unless the policy states otherwise, the term "claim" in "claims-made policy" does not refer to the notice given by an insured to an insurer.[44] Instead, it refers to an assertion of legal right or a demand for relief or payment by a third party against the insured for an alleged wrongful act.[45] Although the claim can be initiated by a civil, criminal, or administrative proceeding,[46] "[i]t is well-settled that a written demand for money generally constitutes a claim."[47]

Second, to trigger coverage, the claim must assert a wrongful act committed by the insured in the individual's official capacity as a D&O.[48] "'Wrongful act' means any breach of duty, neglect, error, misstatement, misleading statement, omission or act by the directors and officers of the company in their respective capacities as such, or any matter claimed against them solely by reason of their status as directors and officers of the company."[49]

Third, the insured must experience a loss.[50] A loss of an "individual insured is generally defined as any amount for which the insured is legally liable and that arises out of a claim against him for wrongful acts."[51] A claim for breach of contract would not be covered because being required to pay what an insured already

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[41] *Id.* at § 12:6.
[42] DAVISSON ET AL., *supra* note 4, at 39.
[43] *Id.*
[44] OLSON ET AL., *supra* note 2, at § 12:7.
[45] *Id.*; DAVISSON ET AL., *supra* note 4, at 39.
[46] OLSON ET AL., *supra* note 2, at § 12:7.
[47] DAVISSON ET AL., *supra* note 4, at 39.
[48] *Id.* at 48.
[49] OLSON ET AL., *supra* note 2, at § 12:9.
[50] *Id.* at § 12:12.
[51] *Id.*

agreed to pay is not a wrongful act, and thus, there is no loss.[52] Also, many policies define loss to "exclude punitive damages, fines, penalties, sanctions . . . ."[53]

When the above three preliminary requirements are satisfied, the next question is whether the claim is barred by an exclusion provision contained within the D&O insurance policy.[54]

V. EXCLUSION PROVISIONS

Generally speaking, exclusion provisions under a D&O insurance policy fall under three categories: "(1) exclusions relating to specific conduct of an insured [("conduct exclusions")]; (2) exclusions of coverage provided under other policies; and (3) exclusions relating to issues of public policy or areas of difficult exposure."[55] The first category, conduct exclusions, typically relates to "claims based on: (1) [i]llegal remuneration; (2) [s]hort-swing profits; and (3) criminal or deliberately fraudulent acts, or . . . personal profit[s] or advantage[s] to which the insured is not legally entitled."[56]

A. Deliberate-Fraud Exclusion

While D&O policies are generally intended to cover negligent acts of D&Os, the deliberate-fraud exclusion "is intended to remove from coverage claims arising from intentionally fraudulent or dishonest behavior."[57] A typical fraud-exclusion provision is phrased as follows: "The [insurer] shall not be liable . . . on account of any [c]laim made against any [i]nsured [p]erson . . .

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[52] *Id.*
[53] DAVISSON ET AL., *supra* note 4, at 70.
[54] OLSON ET AL., *supra* note 2, at § 12:13.
[55] *Id.*
[56] *Id.* at § 12:14.
[57] DAVISSON ET AL., *supra* note 4, at 118.

based upon, arising from, or in consequence of any deliberately fraudulent act or omission . . . ."[58] In theory, a fraud-exclusion provision applies only when there is an actual finding of fraud against the insured.[59] But how to establish a fraud to trigger the fraud exclusion remains a critical issue.[60]

The court in *Alstrin* looked at the broad definition of the term "claim" under an insuring agreement and held that the D&O insurance policy should cover deliberate fraud in securities claims, and that limiting the coverage only to reckless or negligent conduct would conflict with the plain language of the policy.[61] The D&O insurance policy covered "Securities Claims," but excluded "claims 'arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraud.'"[62] The insurer argued that, although the underlying action involved a securities class action, coverage should have been denied because of the "deliberate fraud" exclusion provision.[63] The court disagreed and held that

> [i]f the deliberate fraud exclusion applied to securities claims, there would be little or nothing left to that coverage. Particularly, in a D & O insurance policy, where securities fraud claims are among the most common claims filed against directors and officers, the effect of such an exclusion would be particularly devastating. No insured would expect such limited coverage from a policy that purports to cover all types of securities fraud claims.[64]

Some courts have held that fraud-exclusion provisions apply only when there is a finding of fraud material to the adjudicated cause of action, especially when the fraud-exclusion provision

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[58] ABRAHAM, *supra* note 36, at 594.
[59] DAVISSON ET AL., *supra* note 4, at 118.
[60] Rutkin, *supra* note 5, at 25.
[61] Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376, 397-98 (D. Del. 2002).
[62] *Id.* at 384.
[63] *Id.* at 396.
[64] *Id.* at 398.

contains the term "adjudication."[65] In *AT & T*, the parties replaced the term "in fact" with the term "adjudication" under the fraud-exclusion provision.[66] The court held that the fraud-exclusion provision would not bar coverage "*unless* (1) there is a 'finding' that such [fraudulent] acts occurred, and (2) that such finding is 'material' to the cause of action being adjudicated."[67] Because the insured and third party settled the claim without adjudication or a finding of fraud, the court held that the fraud-exclusion provision did not apply.[68]

When a fraud-exclusion provision uses the term "in fact," rather than "adjudication," some evidentiary proof may be sufficient to trigger the fraud exclusion.[69] In *PMI*, the fraud-exclusion provision applied to claims "arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraudulent act[.]"[70] The court held that "the term 'in fact' . . . should be read to require *either* a final adjudication, including a jury adjudication, *or* at a minimum, at least some evidentiary proof . . . ."[71]

These cases show that courts are split on how to interpret fraud-exclusion provisions under D&O insurance policies. In *Alstrin*, the court basically ignored the "in fact" language and de-emphasized the fraud-exclusion provision.[72] By focusing on the broad definition of "claim" and the insured's reasonable expectation, the court held that the D&O insurance policy should cover deliberately fraudulent acts in securities claims.[73] This holding directly conflicts with the general insurance concept that

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[65] *See e.g.*, AT & T v. Clarendon Am. Ins. Co., No. 04C-11-167-JRJ, 2008 WL 2583007 (Del. Super. Ct. June 25, 2008); In re Donald Sheldon & Co., 186 B.R. 364, 370 (Bankr. S.D.N.Y. 1995).
[66] *AT & T*, 2008 WL 2583007, at *7.
[67] *Id.* at *6.
[68] *Id.* at *6-7.
[69] *See* PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., No. C 02-1774 PJH, 2006 WL 825266, at *8 (N.D. Cal. Mar. 29, 2006).
[70] *Id.* at *8.
[71] *Id.* at *7.
[72] *See* Alstrin v. St. Paul Mercury Ins. Co., 179 F. Supp. 2d 376 (D. Del. 2002).
[73] *Id.* at 398.

intentional misconduct should not be covered. In *AT & T*, the court held that adjudication of a fraudulent act is necessary to trigger the fraud exclusion.[74] It went further and held that once an underlying claim is settled, the fraud-exclusion provision becomes inapplicable.[75] As a result, it creates incentives for the insured to settle the underlying claims at the expense of an insurer's interests to challenge a fraud. In *PMI*, the court focused on the term "in fact" and held that both adjudication and some evidentiary proof can trigger the fraud exclusion, but it left the "some evidentiary proof" standard undefined.[76]

B. Alstrin*: Problematic Reasoning and Holding*

In *Alstrin*, the D&O insurance policy agreed to pay the loss of every director or officer "arising from a [c]laim first made . . . during the [p]olicy [p]eriod . . . for any actual or alleged wrongful act in their" official capacity.[77] The term "claim" was defined in the policy to cover securities claims, including claims made against the insured under the 1933 Securities Act and the 1934 Securities Exchange Act.[78] But the fraud-exclusion provision excluded claims "arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraud."[79]

The court held that deliberate fraud exclusion provisions do not apply to securities claims because "securities fraud claims are among the most common claims filed against directors and officers, the effect of such an exclusion would be particularly devastating."[80] It also reasoned that no one purchasing a policy that

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[74] AT & T v. Clarendon Am. Ins. Co., No. 04C-11-167-JRJ, 2008 WL 2583007, at *6 (Del. Super. Ct. June 25, 2008).
[75] *Id.* at *7.
[76] PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., No. C 02-1774 PJH, 2006 WL 825266, at *8 (N.D. Cal. Mar. 29, 2006).
[77] *Alstrin*, 179 F. Supp. 2d at 383.
[78] *Id.* at 396.
[79] *Id.* at 384.
[80] *Id.* at 398.

provides coverage for securities claims under the 1933 Securities Act and the 1934 Securities Exchange Act would intend to purchase such restricted coverage.[81] Its holding and reasoning are problematic for several reasons.

First, insurance policies are "intended to cover accidental or unexpected events."[82] "[I]nsurance companies uniformly include in policies an 'intentional act' . . . exclusion . . . ." [83] There is no sound reason to carve out a special area and protect D&Os' intentional misconduct under the securities law.

Second, it is normal for an insurance policy to contain a broad coverage-grant language in the beginning and subsequently list the detailed exclusion provisions.[84] But the court in *Alstrin* ignored this common practice, de-emphasized the function of exclusion provisions, and held that the specific fraud-exclusion provision conflicted with the broad coverage-grant language.[85]

Third, the court's statement that "securities fraud claims are among the most common claims filed against directors and officers" ignored the fact that D&Os' liability can arise from many sources other than securities claims, such as breach of fiduciary duties and violation of various regulations.[86]

Fourth, the court overstated the potential impact caused by the deliberate-fraud exclusion in securities-law claims. D&Os do not have reasonable expectation of coverage for their intentional misconduct because most of their liabilities under the securities law can be established by negligent or reckless acts without a finding of intent.

The 1933 Securities Act provides three major liability provisions: (1) civil liabilities on account of false registration statement;[87] (2) civil liabilities arising in connection with

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[81] *Id.*
[82] JEFFREY JACKSON, MISSISSIPPI INSURANCE LAW AND PRACTICE § 16:13 (2014 ed.).
[83] *Id.*
[84] OLSON ET AL., *supra* note 2, at § 12:5.
[85] *Alstrin*, 179 F. Supp. 2d 376.
[86] *Id.* at 398.
[87] 15 U.S.C.A. § 77k (West 2015).

prospectuses and communications;[88] and (3) fraudulent interstate transactions.[89] Among these provisions, only one subsection of the fraudulent interstate transactions provision requires a finding of intent.[90]

Under the 1934 Securities Exchange Act, most anti-fraud claims are based on Section 10(b) of the Exchange Act and Rule 10b-5 (employment of manipulative and deceptive devices) promulgated by the SEC.[91] Most courts have held that recklessness is enough to meet the scienter element and intent is not necessary.[92] While the line between reckless and intentional is fuzzy, courts in the U.S. seem to have no trouble making such distinctions.

In response to the *Alstrin* decision, some D&O insurance policies began replacing "deliberate fraud" language with "adjudicated fraud" language, which requires adjudication of a fraudulent act to trigger the fraud-exclusion provision.[93] Some courts have also held that a fraudulent act must be adjudicated to satisfy the fraud-exclusion provision.[94]

C. AT & T*: Adjudication or Settlement*

In *AT & T*, the court held that fraud-exclusion provisions do not bar coverage for a fraudulent act "*unless* (1) there is a 'finding' that such acts occurred, and (2) that such finding is 'material' to the cause of action being adjudicated."[95] It further held that settlement of the underlying claim will bar the application of the

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[88] 15 U.S.C.A. § 77l (West 2015).
[89] 15 U.S.C.A. § 77q (West 2015).
[90] *See id.*
[91] 15 U.S.C.A. § 78j (West 2015); 17 C.F.R. § 240.10b–5 (2014).
[92] *See*, *e.g.*, 15 U.S.C § 77j(b) (2012); S.E.C. v. Infinity Grp. Co., 212 F.3d 180, 192 (3d Cir. 2000).
[93] ABRAHAM, *supra* note 36, at 594.
[94] *See* AT & T v. Clarendon Am. Ins. Co., No. 04C-11-167-JRJ, 2008 WL 2583007, at *6 (Del. Super. Ct. June 25, 2008).
[95] *Id.*

fraud-exclusion provision.[96] This holding motivates an insured to settle the underlying claim to avoid a finding of fraud and to secure coverage, but it ignores an insurer's legitimate interest to challenge a fraud, even if the fraud is clear.

Although it is true that D&Os have legitimate interests in settling groundless claims or claims against them based on non-intentional conduct, these legitimate interests can be protected by the D&O insurance policy because an insurer has a duty to defend an insured.[97] A duty to defend "is triggered whenever there is a remote possibility of coverage under the insurance policy."[98] "It is the allegation itself and whether the allegation arguably falls within the policy that creates the duty to defend, not whether the claim will eventually be excluded."[99] The duty to defend is broader than the duty to indemnify.[100] "Even if a claim ultimately falls outside of a policy, the insured may still be required to defend the insured against [the underlying claim]."[101] "When an insurer refuses to defend a covered claim[,] the insured is entitled to damages proximately caused by that failure, including attorney's fees and expenses."[102] There is no reason to prevent an insured from settling an underlying claim; however, "[i]t would seem only to make sense that where the [insured] settles the underlying fraud action before trial—and hence before the [insured's] dishonesty has been determined—the insurer should be permitted to subsequently litigate the issue so as to apply the exclusion."[103]

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[96] *Id.* at *7-8.
[97] *See* Gray v. Zurich Ins. Co., 419 P.2d 168 (Cal. 1966).
[98] OLSON ET AL., *supra* note 2, at § 12:32.
[99] *Id.*
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] Rutkin, *supra* note 5, at 25.

D. PMI*: An Ambiguous "Some-Evidentiary-Proof" Standard*

In *PMI*, the court held that the term "in fact" within the fraud-exclusion provision means "*either* a final adjudication, including a judicial adjudication, *or* at a minimum, at least some evidentiary proof" of fraud.[104] However, what evidence, and how much evidence, can satisfy this relaxed "some evidentiary proof" standard? Once the "adjudication" approach is replaced with the "in fact" approach, the application of fraud exclusion becomes even more ambiguous. A recent California case reflects this ambiguity.[105]

The D&O insurance policy fraud-exclusion provision may be triggered even when there is no actual finding of intent, so long as some evidence supports such a finding.[106] In *Nat'l Bank of California*, parties to a D&O insurance policy replaced the term "final adjudication" with the term "in fact."[107] The insured bank induced its customer trustees to execute fifteen loans documents without telling the trustees about the underlying loan. The arbitration award concluded that the bank's conduct was fraud in execution, and thus triggered the fraud exclusion under its D&O insurance policy.[108] But the arbitrator made no finding as to the bank's intent. Instead, the arbitrator only found that the bank did not tell the trustees about the underlying loan before the documents were executed, and that the bank handled the documents in a way that customer trustees were unable to read them.[109] The court held that the evidence submitted to the arbitrator was sufficient to trigger the fraud exclusion under the D&O insurance policy.[110]

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[104] PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., No. C 02-1774 PJH, 2006 WL 825266, at *7 (N.D. Cal. Mar. 29, 2006).
[105] See Nat'l Bank of Cal. v. Progressive Cas. Ins. Co., 938 F. Supp. 2d 919 (C.D. Cal. 2013).
[106] *Id.*
[107] *Id.* at 925 ("Any [c]laim arising out of or in any way involving, in fact, any fraudulent, dishonest or criminal act . . . .").
[108] *Id.* at 927.
[109] *Id.*
[110] *Id.* at 931.

From *PMI* and *Nat'l Bank of California*, it can be concluded that once the "in fact" approach and the relaxed "some-evidentiary-proof" standard come into play, the evidentiary requirement and the level of burden of proof for applying the fraud exclusion become even more ambiguous.

E. Which Approach Should Be Applied?

The "adjudication" approach requires a final adjudication of a fraudulent act to trigger the fraud-exclusion provision.[111] This approach is strict, but clear. An insurer cannot easily enforce the fraud-exclusion provision; thus, it better protects the insured's reasonable expectation to coverage.

In contrast, the "in fact" approach requires either a final adjudication or some evidentiary proof to trigger the fraud exclusion.[112] Its relaxed "some-evidentiary-proof" standard provides an insurer more leeway to enforce the fraud-exclusion provision; thus, it better serves the insurer's interests in preventing fraud.

An insured has legitimate interests in settling an underlying claim, but an insurer's interests in challenging and preventing fraud are also important. To strike a balance between these interests, the insurer should be allowed to subsequently challenge a fraud and raise the fraud-exclusion provision.

"The well-established body of law across the nation . . . recognizes that the essence of insurance is peace of mind."[113] The purchasers of insurance are not contracting "to obtain a commercial advantage but to protect [themselves] against the risks of accidental losses and the mental stress which could result from

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[111] AT & T v. Clarendon Am. Ins. Co., No. 04C-11-167-JRJ, 2008 WL 2583007, at *6 (Del. Super. Ct. June 25, 2008).

[112] PMI Mortg. Ins. Co. v. Am. Int'l Specialty Lines Ins. Co., No. C 02-1774 PJH, 2006 WL 825266, at *7 (N.D. Cal. Mar. 29, 2006).

[113] Jeffrey M. Liggio & P. Scott Russell IV, *The Price of Peace of Mind - Recovery of Mental Distress Damages in Bad Faith Claims in Florida*, 75 FLA. B.J. 44, 44 (2001).

such losses."[114] "[O]ne of the primary reasons a consumer purchases any type of insurance . . . is the peace of mind and security that it provides in the event of loss."[115] The "adjudication" approach should be the preferred choice because it better gives insureds sound peace of mind. For the same reason, the insurer should be allowed to subsequently challenge the fraud *only if* it can meet the heightened pleading requirement and can prove the fraud by clear and convincing evidence.

VI. CONCLUSION

Under D&O insurance policies, the term "adjudication" and the term "in fact" contained in the fraud-exclusion provision affect the parties' interests in different ways. Although parties to the policy generally can agree to any lawful terms as they see fit,[116] the "adjudication" approach should be the preferred approach. In addition, an insurer should be allowed to challenge a fraud after the underlying claim is settled, but only if the insurer could meet the heightened evidentiary threshold.

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[114] *Id.* at 48 (citing McCorkle v. Great Atl. Ins. Co., 637 P.2d 583, 588 (Okla. 1981)).
[115] *Id.*
[116] SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 49:1 (4th ed. 2014).